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Backgrounder

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Let's Defend the Dollar — With Lower Interest Rates!

by

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Once again, the Canadian dollar is hitting new lows against the US dollar. And once again, the currency's slide is prompting calls for the Bank of Canada to defend it with higher interest rates.

If this advice appears a bit suspect, it should. Only a few months ago, the Bank reacted to the declining dollar by hiking short-term interest rates. Now that the damaging effects of that rate hike on the economy are becoming clear, the currency looks feebler than ever. This time, we should try something different. What the plunging dollar really needs from the Bank is an interest rate cut.

Conventional wisdom says that foreign exchange traders would respond to an interest rate cut by hammering the dollar down. But the dollar's movements are driven by a variety of forces. Longer-term trends are set by the rate of inflation in Canada relative to that in the United States and also by relative rates of productivity growth in the two countries. Over the shorter term, changes in Canada's trade picture matter: the dollar moves up when foreign demand for Canada's exports strengthens and their prices rise; it moves down when demand weakens and prices fall. The relative strength of the Canadian economy is also key over the shorter term: a stronger economy offers higher returns to holders of Canadian assets, increasing demand for the dollar; a weak economy has the opposite effect.

Over the past several years, only one of these forces — low relative inflation — has worked in favor of a stronger dollar. The rest of them have pushed it down. Productivity growth in Canada has long been distinctly worse than that in the United States, undermining the currency. More recently, Asia's financial crisis has upset the outlook for Canadian exports and deflated key commodity prices, pushing the dollar lower.

The latest drag on the dollar came, oddly, from the Bank of Canada's attempts in mid-December 1997 and late January 1998 to stem the currency's slide with higher short-term interest rates. Higher rates gave the dollar a temporary bounce, but the relief was short-lived.

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The more important result of tighter monetary policy was to slow the economic expansion from a healthy pace to a crawl. Now that the economy's weakness is becoming visible in the form of flagging consumer spending and anemic job growth, Canada's attractiveness as a place to invest has deteriorated further. The dollar's slide resumed in the spring, and has since gathered pace.

If Canadians really want to see their dollar return to a more respectable level against the US dollar, they need to get beyond a short-term preoccupation with where it will close tomorrow and the day after that. The impact of the Asian slump on Canada's exports and on many key resource industries is not something Canadians can fix. But the long-term problems that have held Canada's productivity growth persistently below that of the United States are another matter.

In particular, alongside a credible multiyear program of *debt reduction*, next year's federal budget should put forward a credible multiyear program of *tax cuts*. Personal income tax cuts would increase the rewards to Canadians who work and save, and reduce the incentive for many of Canada's ablest citizens to seek a living south of the border. Business tax cuts would reduce the tilt of Canada's corporate tax system against the leading-edge industries that hold the greatest promise for future economic growth.

What Canadians definitely do not need is another misdirected attempt at a short-term fix in the form of higher interest rates. A hike in rates large enough and sustained enough to make any difference to the dollar's performance over the next few weeks would probably also tip the Canadian economy into recession by year-end — further discouraging domestic and foreign investors, and increasing the chances that the dollar will enter 1999 even lower than it is today. Worse, a slumping economy would put a big hole in Ottawa's looming fiscal surplus, dimming the prospect for the tax cuts that Canada needs to reverse its long-term relative economic decline.

Much better would be for the Bank of Canada to reverse January's rate hike. The dollar might well take a temporary hit. But, in parallel fashion to this spring's brief jump, the dollar's weakness would shortly be reversed, as a resurging economy lent the currency new strength.

For the sake of the dollar and their own well-being, Canadians need a buoyant economy through the rest of this year, and tax cuts in the spring. So this time, let's respond to a dip in the dollar with something other than hikes in interest rates. Let's cut them instead.

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